**Chapter 7**

**On the ECB Inflation 2020 - 2021 Strategy Review [[1]](#footnote-1)**

Our aim here is twofold: Considering the upcoming 10th GC meeting in December, firstly, to discuss current developments and future prospects of ECB’s monetary policy and, secondly, to provide my own account of the main features of the ongoing ECB Inflation Strategic Review, 2020-21.

Let me start with the Eurozone outlook.

1. **Eurozone outlook**

* Real GDP is projected to fall by 8.0 per cent in 2020(-10% in UK, -5% in Japan, -4% in USA, +2 in China). Real GDP contracted by 11.8 per cent during the second quarter (compared with the previous quarter). In the first quarter, real GDP fell by 3.7 per cent q-o-q, a rebound of 12.7% q-o-q for the third quarter while for the fourth quarter the evidence and forecasts suggest a contraction, a move into negative territory, around -3% q-o-q, making a double-dip recession a likely scenario, far from a V-recovery.
* For 2021, real GDP is projected to rebound by 5.4 per cent, for 2022, real GDP is projected to rise by 3.5 per cent. By the end of the forecast horizon, the level of real GDP would stand 3 per cent below its expected level in the pre-Covid-19 December 2019 projections.
* The composite PMI fell to a four month low of 49.4 in October from 50.4 in the previous month. According to Market, business activity fell back into decline across the Eurozone in October as accelerating growth of manufacturing output was overwhelmed by a steepening deterioration in the service sector amid rising COVID-19 worries.
* HICP inflation is projected to decline from 1.2 per cent in 2019 to 0.3 per cent this year; it is projected to rise to 1.0 per cent in 2021 and to 1.3 per cent in 2022. With inflation running in negative territory for the second month in a row and expected to remain negative until March 2021, two key questions are: (a) how long will it take before headline inflation moves into positive territory? (b) how long will it take before headline inflation *approaches* the 2 per cent level?
* Core inflation decreased to an all-time low of 0.2 per cent in September, down from 1.2 per cent in July. The question that rises here is if core inflation has been de-anchored? With regard to core inflation, that measure had for years provided an anchor of stability -- it had hovered near the 1 per cent level for 60 consecutive months.
* Long-term inflation expectations, as measured by the five-year inflation-linked swap rate, have remained almost unchanged since the September monetary policy meeting, standing at 1.18 per cent on October 23. The *all-time low* of 0.72 per cent was reached in March of this year.
* The euro appreciation implies a tightening of euro area financial conditions. It is interesting that the euro’s appreciation against the dollar, which has amounted to about 10 per cent since March, has corresponded with a 70 per cent expansion of the Fed’s balance sheet compared with a 45 per cent expansion of our balance sheet.
* Total purchases under the Asset Purchase Programme (APP) have amounted to €3 trillion, consisting of holdings of: €2.4 trillion under the PSPP
* Purchases under the new Pandemic Emergency Purchase Programme (PEPP) have reached 620 billion.
* According to the October 2020 Survey of Monetary Analysts (SMA), the probability of the next deposit facility rate change being a rate cut is 30 per cent, compared to 25 per cent in the previous round (September). The expected date of rate lift-off has shifted out by two quarters (from 2023 Q4 to 2024 Q2).
* Also, the expected end of APP has shifted out by two quarters from the second to the fourth quarter of 2023.

Elevated uncertainty about the evolution of the second wave of the pandemic and the economic outlook continued to dampen business investment. Risks to global activity and trade remained tilted to the downside, which implied a potential reduction in foreign demand confronting the euro area. A V-recovery is wishful thinking. This is a COVID recession. A lot will now depend on the severity and duration of the new round of local or generalised lockdowns across Europe (mobility restrictions, business closures, etc). Should the restrictions persist at the current or even tighter levels during Christmas shoping period and well into Q1 2021, the above forecasts for Q4 2020 and 2021 will be exposed to downside risk.

1. **ECB monetary policy: current developments and future prospects**

What should we expect from the ECB in the December meeting?

Despite the rebound in economic activity in Q3, the recovery next year will remain incomplete, uneven and subject to considerable uncertainty. While significant slack remains in the economy, the factor “fear” and weak balance sheets of households and firms both affect negatively consumption and investment decisions. Covid-19 has produced a services-recession, which affects labor-intensive industries, and has a negative impact on the low-skilled resulting in slower recoveries. Other risks include, e.g. if the downturn “feeds on itself”, say via higher precautionary savings, weak bank lending conditions and a large number of enterprises shutdowns.

Needless to say, PEPP is already a huge success in the sense that it has achieved its market stabilization objective. More generally, as President Lagarde stated in a recent interview with Le Monde (19/10/20), thanks to ECB actions, growth will be 1.3 percentage points higher overall, inflation 0.8 percentage point higher, while one million jobs in the euro area were saved. But with core inflation dropping to just 0.2% in September, down from 1.2% in July and the latest forecast of a rise to 1.1 in 2022, a case can be made for monetary policy doing a lot more, if it can deliver the goodies of course! Note that with headline inflation at 0.3% this year and a projection to rise to just 1% in 2021 and the evidence, according to a number of empirical studies at the eurozone, that measured inflation overstates (as high as 1% plus) actual inflation, for some analysts, we are in the euro area already in deflation! Clearly something has to be done about that! If not something in order to address the confusion about the two-step inflation strategy summarized by ECB chief economist Philip Lane, at least as a response to a subdued- if not bad - economic outlook lately. I explain. Back in summer Lane announced a two-step inflation strategy, whereby the projected inflation trajectory would return to where it was before the pandemic in a first step. This suggests that the ECB should care to push the 2022 inflation forecast to 1.6%. But even the latest official forecast for 2022 had headline inflation at 1.3% and core inflation at 1.1%. The upshot of all this is that markets are questioning the ECB’s commitment, in terms of the speed in boosting inflation.

*Possible measures in December*

At the Sintra meeting last week, President Lagarde talked openly for a “recalibration of all policy tools “ in the December meeting with an aim to ensure that financing conditions in the Eurozone “remain favourable” in order to support growth and counteract the negative impact of the pandemic on inflation.

Here is my personal opinion, my educated guess if you like, with my professorial hat on what we should expect from the forthcoming meeting.

Two (near) sure things and one query that may surprise the relevant stakeholders. Firstly, it is quite certain that an increase in the PEPP envelope by at least another 500 bln euro and an extension of the possible purchase horizon by 6 months to the end of 2021 or even into Q1 2022 will be announced. The open-ended APP will continue with its 20bln per month purchases, in other words, a change only to the PEPP because of its flexibility and better response to market stress. The GC may go one step further and try to link the PEPP with forward guidance (e.g. in terms of the two-step inflation strategy to reach the pre-pandemic levels etc.)

Secondly, further changes to TLTRO-IIIs modalities, including additional tenders for the entire 2021 (beyond the two already agreed for December 2020 and March 2021), perhaps a drop in the rate discount from the current -1% and extension of the period over which the discount will apply, say until the end of 2021. An increase in the tiering multiple is also possible along with a further loosening of the collateral framework, to the extent this may be a constraint on additional TLTRO take-up.

Finally, the GC may surprise the markets, signaling the urgency out of the pandemic situation, with a deposit rate cut by 25bp from its current

-0.50% level. Although the economic arguments are strong enough to justify such a move (at the end there is the risk of a deflation in the Eurozone and, equally important, the risk of Eurozone inflation expectations de-anchoring to the downside), the political economy around rate cuts is still difficult with many governors at the GC and in terms of public opinion in core member countries. We may have to cross that bridge however, if there is a resurgence in the FX market and the euro gains popularity among investors (and/or the US $ experiences the opposite) following the clear result in the US presidential elections.

Under Biden’s administration, one expects higher budget deficits and larger US fiscal and current account deficits which contribute to a weaker dollar. A move to 1.2 seems achievable before the euro comes under increased scrutiny from ECB policymakers. We would then be far away from “a sign of confidence to the euro”, as super Mario Draghi stated in a corresponding situation in Febr. 2013. This time is more of a weak dollar.

An ECB recent study estimates that a 10% appreciation of the euro NEER (nominal effective exchange rate) subtracts around 0.4% from inflation with a lag of 12 months. Other empirical studies take the above number close to 1%, presenting in any case a cause of concern for the ECB.

A small digression may be in order here. Past evidence from previous decades suggests that in an environment of great global macroeconomic uncertainty, exchange rate volatility is high. Today with such generalized uncertainty (pandemic, Brexit, US elections etc.) the response of core exchange rates is rather muted, and this is one of the macro puzzles of the pandemic. Possible explanations for that is that we experience a common shock across countries, generous dollar swap lines by the FED, massive fiscal packages around the world and what Kenneth Rogoff labeled as “the paralysis of conventional monetary policy”, implying too low interest rates, what applied econometricians call “volatility clustering” implying low volatility in the FX markets.

In short, I believe the toolkit is unlimited, I don’t see ahead of us currency wars of the type of competitive devaluations. However, I see ahead of us a different type of global currency wars from the issuance of CBDCs, coming from Asia Pacific (digital CNY), the geopolitical attempt to secure a bigger share in the FX global reserve basket, global trade etc. (the advantage of moving first).

*Limits*

On the other hand, it is fair to say also this. The ECB has said recently that its latest measures (1.35 tril of PEPP and very large TLTRO-IIIs) may be boosting annual inflation by a quarter of percentage point. Hence, one may wonder that a new PEPP increase by another 500 bln would still leave inflation too low. In a nutshell, the ECB toolkit is perhaps unlimited (including further negative rates, more asset purchases and more powerful forward guidance, etc.) but its impact on inflation may be limited due to decreasing returns to scale. Apart from financial stability considerations stemming from ultra-accommodative monetary policy plus disincentivising governments not to undertake reforms, the core problem with it (i.e. too loose MP) is that it drives a preference for liquidity, diverting savers and investors from long-term investment. The tradeoff is only between liquidity and risk, leaving aside the notion of return, which has little meaning with too low interest rates.

*Fiscal policy*

That is why perhaps there has recently been strong backing for the fiscal side at the GC level (I have in mind especially the reference for the role the Next Generation EU Fund of 750 bln euro could play, stressing the importance of it becoming operational as soon as possible, found even in the Introductory Statement of President Lagarde in the October meeting, and in a plethora of other speeches and interviews by members of the Executive Board and governors). Real money spending will start in the second half of next year unless there is a further delay due to the veto imposed by Hungary and Poland because of rule-of-law strings attached to the disbursements. Very few would disagree that, amid the pandemic crisis, money from the above Fund that goes directly to targeted productive public spending together with growth-enhancing structural policies would contribute significantly to a steady return to normality, which is the ultimate objective.

**3. A dovish ECB Strategic Review 2020-21**

Thanks to a changing economic landscape due to the pandemic and Fed’s monetary policy important shift in emphasis, it is expected that the discussions surrounding the ECB’s Inflation Strategic Review 2020—21 will undoubtedly be affected towards a dovish direction, which in practice would imply even lower for longer interest rates.

One word on Fed’s inflation targeting (IT) framework: In this year's Jackson Hole symposium, Federal Reserve Chairman Powell announced that the Fed adopts a new flexible average inflation targeting framework that "seeks to achieve inflation that averages 2% over time". As a result, this new policy framework avoids setting a time-horizon over which the Fed seeks to average 2% inflation, but emphasizes that the Fed will target an inflation overshoot in recoveries, following low inflation during downturns. Another significant change in the Fed’s strategy is the shift from “deviations” from full employment to “shortfalls” in it, which implies that low unemployment in itself will no longer justify tighter policy unless there are clear inflationary pressures.

I doubt that the ECB will follow FED’s steps in adopting the average inflation targeting regime which, in practice, would mean no interest rate hikes when inflation overshoots its target (say 2%). I doubt it in terms of political economy. The hawks in the GC would never accept that, nor would the general public in the core northern countries. Average IT regime compared to IT or PLT is a more dovish monetary policy stance. The idea that a CB targets a higher rate of inflation for the next three years in order to make up for past undershoots, the statutory aim of which is to achieve an inflation target average.

I also doubt that price level targeting will be adopted, namely the idea that there is a price level target path, implied by a target inflation rate, and policy should aim to tackle deviations above all below that predetermined path. In theoretical terms, perhaps it is superior to IT, its key advantage is that it is countercyclical through its immediate impact on inflation expectations, whereas its key disadvantage is that it is difficult to explain to the public, to communicate efficiently with those who form inflation expectations!

The ECB’s only previous strategy review that took place in December 2002, concluded with two major changes: the inflation objective was clarified as “below, but close to, 2%” and de-emphasised money growth (M3). Instead, it adopted the two-pillar approach, comprising economic analysis (more short-term) and monetary analysis (more medium-term).

This time the Review is taking place against a backdrop of too low for too long rates, a loose relationship between unemployment and inflation (a very flat Phillips curve) combined with a secular reduction in the equilibrium interest rate. All in all, the risk that price expectations disanchor has tilted to the downside.

The Review was launched last January, to be concluded by first half next year, and has a broad remit, covering 12 areas from climate change, digitalization, monetary and fiscal policy interaction, price stability objective and inflation expectations and measurement, communication, etc.

I provide below my own personal account on the ECB’s possible options. There will be modifications to the existing IT but my bet is that the ECB will say something like: “Better the devil that you know”. An improved IT framework is my bet where past deviations would not guide future policy choices. It is a credible, discretionary rule monetary policy framework, easy to communicate and understand by the general public and the markets. On its negatives, it is of course the expost asymmetry, namely that inflation outcomes can be always found on one side of the inflation target.

I confine myself only to the following 6 areas.

* *A more symmetric inflation target* It seems that the long-held expectation will be fulfilled: i.e. a move to a more symmetric inflation target by removing “below, but close to” from its definition. By doing so, the ECB would signal to the relevant stakeholders the notion that the cost of undershooting inflation is equivalent to the cost of overshooting it, plus of course, the moderate increase on the target inflation (symbolism does matter for inflation expectations) to 2% from the current somewhat below 2%. The greater precision in the definition of the target could work towards anchoring (higher) inflation expectations, which is the ultimate objective after all.
* *A new narrative*the new dovish stance may be signaled through a new narrative on its mandate and changes to its price stability definition. While the ECB’s formal mandate is not under discussion and review, as it is set by the Treaties, the narrative around it could be modified in line with the Fed’s mandate of full employment (provided, of course, that there is no prejudice to ECB’s statutory target of price stability), which in practice could imply a more decisive policy reaction, say, in an attempt to close the output gap at a eurozone level or even to shorten cross-member states growth divergences (core vs periphery), and so on.

The above two changes combined could set the basis for a greater urgency today in correcting undershooting and in the future a higher tolerance for overshooting its inflation objective.

* *Horizon*Another modification could well be in terms of the horizon of achieving the inflation target. More precisely, to move from “over the medium term” to “over the cycle”. This might have a couple of effects: firstly, while maintaining flexibility, it would shorten the convergence to the target (sooner than in medium term) and, secondly, it would underline more clearly that past inflation performance is taken into account in the overall assessment for future monetary policy actions.
* *Fragmented financing conditions* In the aftermath of the pandemic crisis, and from a macroprudential point of view, the problem of non-performing loans (NPLs) (legacy loans and the new COVID ones) will have to addressed, especially in the South, which has been a major concern for supervisors, policymakers and market participants in the euro periphery area. This holds particularly true for the most vulnerable countries such as Greece, Italy, Portugal and Cyprus (Figure 15). More precisely, banks in Greece and Cyprus still report the highest NPL ratios in the EU (37.4% and 21.1% respectively), and they are still facing challenges to clean up their balance sheets and move closer to the EU average NPL ratio which, at end-September 2019 was around 2.9%. More generally, and with regards to the financial sector, the issue of fragmentation is still an obstacle. For instance, the strength of the relationship between business investment and bank lending to corporates still differs markedly across euro area countries. The growth in lending to non-financial corporations has increasingly diverged. Bank lending to corporates has developed in line with business investment in Germany and France, whereas a sizeable gap can be observed, especially in Spain and Italy (pre and post-COVID).
* *Climate change*for the first time in history, more and more central banks deal with the fight against climate change and its environmental consequences, adopting green finance practices. Developing a comprehensive analytical framework to assess the potential impact of climate change and transition to low-carbon on financial stability seems to be a crucial challenge for central bankers. Four are the priorities here: firstly, risk assessment models by central banks have to be modified in order to take better account e.g. in their collateral frameworks of climate-related risks. Secondly, in their various QE programmes for monetary policy purposes, asset purchases should have a sustainability-linked dimension, even if deviating from the principle of market neutrality. Thirdly, central banks as asset managers should incorporate ESG practices in managing their own portfolios, nor the more so when such investing, in volatile periods, outperforms the conventional one. Last but not least, from a supervisory point of view and in assessing the resilience of the financial system, in the current easing of countercyclical instruments for banks and insurance companies, equal consideration should be given to climate-related risks. Last September, the ECB decided to accept sustainability-linked bonds as collateral for Eurosystem monetary policy purposes, a very welcome move indeed! One last word on climate change, a word of caution if you like. Central banks shouldn’t go too far with climate change. A more active involvement of central banks on climate change policies might be controversial, as it may be regarded as falling outside the scope of their mandates and could well undermine the very independence upon which these institutions rely. Hence, the broader question remains: Should central banks assume responsibility for implementing policies to combat climate change? I hope the Review comes up with clear- cut answers on this.
* *Digital euro.*Last remarks on a digital euro. Three weeks ago or so the ECB published a high profile “Report on a digital euro”, with a joint Introduction by President Lagarde and my former colleague at the Bank of Italy and friend Fabio Panetta, now a powerful man in the Executive Board. The Report examines the issuance of CBDC from the Eurosystem perspective: A digital euro would be just another way to supply euro, not a parallel currency, by definition risk-free central bank money, widely accessible on equal terms to users in all euro area countries, to be fully trusted. The Report is rather thin on monetary policy and this is, I believe, deliberate (the ECB may want to buy time, no rush, there are other urgencies right now like the pandemic, the risk of deflation, etc.) As it states in the Report “on monetary policy considerations … this could emerge in the future on the basis of further analysis”. It rather focuses on the issues that justify the issuance at first place of a digital euro (7 real world plausible scenarios and implied requirements, operational aspects and implications for the payment systems, etc.) Last week I gave a full lecture in a webinar in Singapore with a large and lively audience on CBDC and Monetary Policy, let me here try to share with you my main points:

1. Τhe introduction of CBDC could change the framework in which central banks conduct monetary policy, affecting both the implementation and transmission of monetary policy.
2. CBDC (either retail or wholesale) would substitute other payment methods supported by banking deposits with ultimate effects on the money supply since it may influence the monetary base (depending on the degree of substitution between deposits and traditional currency, the selected design and the amount of CBDC issued) and/or the money multiplier. For instance, due to the existing fractional reserve banking system, the impact on the money multiplier may be triggered from, say, a switch from excess reserves to CBDC.
3. More generally, a CBDC could be seen as a productivity shock in the financial system, with a deflationary impact and a negative effect on bank profitability. Furthermore, as a structural change altering the informational content of monetary aggregates, changing the velocity of circulation, the term structure of interest rates including the effective lower bound, QE efficiency and money market rates.
4. Finally, a word of caution (another one!) with regards to the potential risks of a central bank digital currency (CBDC), which would *inter alia* allow the public to have electronic deposits at the central bank. I would like to stress that this close link of a central bank to the general public could pose reputational risks – and this is something potentially worrying in terms of politicizing a central bank. I myself prefer a “at arm’s length“relationship with the public and other stakeholders in general, including governments.

Needless to say, there is no guarantee at all that the completion of the ECB’s strategic review will in fact deliver a higher headline and core inflation. This remains to be seen. It’s not an easy task (see BoJ recent case—at best a lift in inflation expectations or nothing at all).

1. Opening remarks at webinar organized by LC Macro advisors, chaired by Lorenzo Codogno, hosted in London on the 18th November 2020. [↑](#footnote-ref-1)